Canadian Overseas Petroleum Limited
(formerly Velo Energy Inc.)
Consolidated Financial Statements
As at and for the years ended December 31, 2010 and 2009

Management's Responsibility for Financial Statements

The information provided in these financial statements, is the responsibility of management. In the preparation of the statements, estimated are sometimes necessary to make a determination of future values for certain assets or liabilities. Management believes such estimates have been based on careful judgments and have been properly reflected in the accompanying financial statements.

Management maintains a system of internal controls to provide reasonable assurance that the Company's assets are safeguarded and to facilitate the preparation of relevant and timely information.

Deloitte & Touche LLP was appointed by the shareholders to serve as the Company's external auditors. They have examined the financial statements and provided their auditor's report. The audit committee has reviewed the financial statements with management and the auditors, and has reported to the Board of Directors. The Board of Directors has approved the financial statements as presented.

Signed "Arthur S. Millholland"
Arthur S. Millholland
President and Chief Executive Officer
March 29, 2011

Signed "Aleksandra Owad"
Aleksandra Owad
Chief Financial Officer
March 29, 2011

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Canadian Overseas Petroleum Limited

We have audited the accompanying consolidated financial statements of Canadian Overseas Petroleum Limited (the "Company"), which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended, and the notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) "Deloitte & Touche LLP"

Chartered Accountants

Calgary, Alberta
March 29, 2011

Canadian Overseas Petroleum Limited
Consolidated Balance Sheets
(in thousands of Canadian dollars)

	December 31, 2010	December 31, 2009
Assets		
Current		
Cash and cash equivalents	**$ 37,373**	$ 1,409
Term deposits	**30**	30
Accounts receivable	**83**	75
Prepaid expenses	**22**	277
	37,508	1,791
Long-term rent deposit and prepayments	**43**	70
Office equipment	**59**	70
	$ 37,610	$ 1,931
Liabilities		
Current		
Accounts payable and accrued liabilities *(notes 10)*	**$ 989**	$ 1,901
Loan *(note 4)*	**-**	1,802
	989	3,703
Shareholders' Equity (Deficiency)		
Share capital *(note 5)*	**41,833**	8,063
Warrants *(note 6)*	**11,007**	306
Contributed surplus *(note 6)*	**4,317**	1,074
Deficit	**(20,536)**	(11,215)
	36,621	(1,772)
	$ 37,610	$ 1,931

Nature of operations (note 1)
Commitments and contractual obligations (note 8)

See accompanying notes to the consolidated financial statements.

Approved on behalf of the Board:

Signed "Arthur S. Millholland"
Director

Signed "J. Christopher McLean"
Director

Canadian Overseas Petroleum Limited
Consolidated Statements of Operations, Comprehensive Loss and Deficit
(in thousands of Canadian dollars except per share amounts)

	2010	2009
Revenue		
Management services	**$ 6**	$ 5
Expenses		
General and administrative	**5,590**	2,420
Interest and financing charges	**461**	22
Depreciation	**11**	1
Foreign exchange loss	**39**	1
Stock-based compensation *(note 5c)*	**3,243**	785
	9,344	3,229
Other items		
Interest income	**17**	34
Net loss and comprehensive loss	**(9,321)**	(3,190)
Excess of consideration paid over carrying value of assets and liabilities acquired *(note 3)*	**-**	(1,432)
Deficit, beginning of year	**(11,215)**	(6,593)
Deficit, end of year	**$ (20,536)**	$ (11,215)
Loss per share (basic and diluted)	**$(0.32)**	$(0.20)
Weighted average number of shares outstanding	**29,290,398**	16,402,222

See accompanying notes to the consolidated financial statements.

Canadian Overseas Petroleum Limited
Consolidated Statements of Cash Flows
(in thousands of Canadian dollars)

	2010	2009
Cash Provided By (Used In) Operating Activities		
Net income (loss)	**$ (9,321)**	$ (3,190)
Add (subtract) non-cash items:		
Stock-based compensation	**3,243**	785
Finance and service fees	**295**	12
Depreciation	**11**	1
Unrealized loss on foreign exchange	**40**	1
Funds used in operations	**(5,732)**	(2,391)
Net change in non-cash working capital	**(566)**	461
	(6,298)	(1,930)
Financing Activities		
Issuance of common shares and warrants, net of share issue costs	**44,304**	-
Loan / (Repayment of loan)	**(2,000)**	2,000
	42,304	2,000
Investing Activities		
Purchase of term deposits	**-**	(15)
Additions to office equipment	**(2)**	(17)
Purchase of subsidiary *(note 3)*	**-**	20
	(2)	(12)
Increase in cash during period	**36,004**	58
Net effect of foreign exchange on cash held in foreign currencies	**(40)**	-
Cash and cash equivalents, beginning of year	**1,409**	1,351
Cash and cash equivalents, end of year	**$ 37,373**	$ 1,409

Cash and cash equivalents:		
Cash	**$ 36,873**	$ 309
Term deposits	**500**	1,100
	$37,373	$1,409
Interest paid	**$ 96**	$ -

See accompanying notes to the consolidated financial statements.

All amounts (except for share information) are presented in thousands of dollars ("$").

1. NATURE OF OPERATIONS

Canadian Overseas Petroleum Limited ("COPL" or the "Company"), formerly Velo Energy Inc., was incorporated on July 8, 2004 and was originally classified as a Capital Pool Company under Policy 2.4 of the TSX Venture Exchange Corporate Finance Manual and Policies. Effective May 31, 2006, the Company purchased all of the outstanding shares of Velo Energy Ltd. through the issuance of 833,334 common shares (3,333,334 pre-consolidation common shares) of the Company. This arm's length transaction constituted the Company's Qualifying Transaction under the rules of the TSX Venture Exchange ("TSX-V"). The Company's oil and natural gas operations were focused in southern Alberta. On July 9, 2008 the Company sold Velo Energy Ltd. to an unrelated party.

In August 2009, the Company's management and Board of Directors were replaced and COPL's focus was changed to oil exploration and development in the United Kingdom ("UK") Central North Sea.

On October 6, 2009, the Company signed a share purchase agreement to acquire 100% of the outstanding common shares of North Sea Oil Ltd. ("NSO"), a private company incorporated in Alberta, Canada and 100% of the outstanding common shares of North Sea Oil Exploration Limited ("NSOE"), a private company incorporated in England and Wales, UK.

Effective August 3, 2010, the Company's name was changed from Velo Energy Inc. to Canadian Overseas Petroleum Limited and the Company's common shares were consolidated on a one for four basis as discussed in Note 5. Effective August 26, 2010, the Company's UK subsidiary name was changed from North Sea Oil Exploration Limited to Canadian Overseas Petroleum (UK) Limited ("COPL UK").

On November 23, 2010, the Company filed a prospectus to obtain financing for its operations in the UK North Sea. The offering provided for the total gross proceeds of $130 million (approximately $122.1 million net, after agent's fee and estimated offering costs) to be released to the Company upon certain conditions. The first release condition was met on December 1, 2010 and $36.6 million was released from escrow; the second release condition was met on February 22, 2011 and the remaining funds of $85.5 million (net of agent's fee) were released to the Company. The offering is discussed in detail in Note 5.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements of the Company are prepared in accordance with Canadian generally accepted accounting principles ("GAAP").The consolidated financial statements include the accounts of COPL and subsequent to December 7, 2009, the accounts of its wholly-owned subsidiaries NSO and COPL UK. See *Note 3*.

All inter-company transactions and balances have been eliminated on consolidation.

Measurement Uncertainty

The preparation of consolidated financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions and to use judgment regarding assets, liabilities, revenues and expenses. Accordingly, actual results may differ from those estimated amounts and such differences could be significant.

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Cash and Cash Equivalents

Cash and cash equivalents include cash in banks and short-term deposits with a maturity date of less than 90 days on the date of purchase.

Term deposits

Term deposits are cashable investment certificates with original maturity of longer than three months and less than one year.

Office Equipment

Office furniture and equipment are recognized at cost net of depreciation calculated on a straight line basis at 20% per year.

Future Income Taxes

The Company follows the liability method of accounting for income taxes, whereby future income tax assets and liabilities are recognized for the difference between the tax bases of assets and liabilities and their carrying amounts in the financial statements. The effect of a change in income tax rates on future income tax assets and liabilities is recognized in income in the period in which the change is substantively enacted. A valuation allowance is recorded against any future income tax asset if the Company is not more likely than not to be able to utilize the associated tax deductions.

Foreign Currency Translation

Monetary assets and liabilities denominated in a foreign currency are translated at the exchange rate prevailing at the balance sheet date. Non-monetary assets and liabilities and transactions denominated in a foreign currency are translated at the exchange rates in effect at the transaction date.

Integrated foreign subsidiaries are accounted for using the temporal method. Under this method, monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Non-monetary assets are translated at historical rates. Revenue and expenses are translated at average rates for the period. Foreign exchange gains and losses are included in net loss in the period in which they arise. Depreciation expense is translated at the same historical exchange rates as the assets to which it relates.

Revenue Recognition

Management services revenues are recognized at contractual amounts as the related services are provided. The Company recognizes interest income as it is earned.

Prospect Evaluation Expenses

The Company expenses amounts incurred in the evaluation and development of potential business ventures until related business arrangements are consummated. Project-related costs incurred thereafter are capitalized and amortized over the life of the project. These costs are assessed at least annually for impairment based on expected future cash flows.

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock-Based Compensation

The Company follows the fair value method of accounting for stock options. A Black-Scholes option-pricing model is used to determine fair value at the time the options are granted. The related expense is amortized to earnings over the options' vesting period with a corresponding increase in contributed surplus. Consideration received on the exercise of an option is credited to share capital, along with the related stock-based compensation previously recognized in contributed surplus.

Leases

The Company classifies leases entered into as either capital or operating. Leases that transfer substantially all of the benefits and risks of ownership to the Company are accounted for as capital leases. All other leases are accounted for as operating leases and rental payments are expensed on a straight-line basis over the life of the related lease.

Per Share Data

Basic net income (loss) per share is calculated using the weighted average number of shares outstanding during the year. The treasury stock method is used to calculate diluted earnings per share. This method assumes that only in-the-money stock options and warrants are exercised and that any proceeds would be used to purchase common shares at the average market price during the year.

Financial Instruments

All financial instruments are initially recognized at fair value on the balance sheet. The Company has classified each financial instrument into one of the following categories: held-for-trading (assets and liabilities), loans and receivables, financial assets available-for-sale, financial assets held-to-maturity, and other financial liabilities. Transaction costs related to financial instruments other than those classified as "held-for-trading" are added to the initial carrying amount. Subsequent measurement of financial instruments is based on their classification.

Financial assets and liabilities "held-for-trading" are subsequently measured at fair value with changes in those fair values recognized in net earnings. Financial assets "available-for-sale" are subsequently measured at fair value with changes in fair value recognized in other comprehensive income, net of tax.

Financial assets "held-to-maturity", "loans and receivables", and "other financial liabilities", are subsequently measured at amortized cost using the effective interest method.

Comprehensive Loss

The statement of comprehensive loss is comprised of net loss and other comprehensive loss. Currently the Company has no other comprehensive income or loss transactions.

3. PURCHASE OF NSO AND COPL UK

On October 6, 2009, the Company signed a share purchase agreement to acquire 100% of the outstanding common shares of each of NSO and COPL UK (Formerly NSOE) in a non-arm's length transaction for a purchase price of $600 thousand, payable by the issue of 1,000,000 common shares of COPL at a market price of $0.60 per share. The senior management team of COPL was either registered or beneficial shareholders of NSO and COPL UK prior to the acquisition.

At the time of acquisition, COPL UK had a Sale and Purchase Agreement signed to acquire various interests in three oil and gas exploration and development properties located in the UK Central North Sea, however, neither COPL UK and COPL had financing available to close this transaction. Accordingly, the purchase of NSO and COPL UK by COPL was approved by the TSX-V on the condition that the 1,000,000 shares issued were placed in escrow until the Company closed a financing and completed the UK North Sea acquisition. On December 7, 2009 the Company issued 1,000,000 common shares as consideration for the above transaction and these shares were held in escrow until COPL obtained financing in December 2010 and TSX-V approval on February 3, 2011.

The purchase price allocation as at December 7, 2009 was as follows:

Cash	$	20
Term deposits		15
Accounts receivable		15
Prepaid expenses		11
Office equipment		54
Accounts payable and accrued liabilities		(947)
		(832)
Less purchase consideration		600
Excess of consideration paid over carrying value of assets and liabilities acquired	$	(1,432)

The Company acquired, in a related party transaction not in the normal course of operations, net liabilities in NSO and COPL UK of $832 thousand, which was recorded at carrying amounts. The excess of consideration paid over the net liabilities acquired has been recorded as a charge directly to shareholders' equity (deficiency). The transaction was not accounted for as a "Business Combination" as the assets acquired did not meet definition of a business.

As a result of the above transaction, the Company's statement of operations includes the operating results of NSO and COPL UK from December 7, 2009.

4. LOAN

On December 11, 2009, the Company signed a Bridge Loan agreement for $2.0 million with Endeavour Financial Corporation (“Endeavour”) to finance the Company’s working capital needs. The Bridge Loan maturity was December 14, 2010 and the loan bore interest at a rate of 10% per annum, payable at maturity or an earlier repayment date. If the loan was not repaid in full by April 1, 2010, a fee of $167 thousand was to be paid to Endeavour in cash or by issuing common shares (see Note 5a ii).

In addition, the Company granted Endeavour 300,000 share purchase warrants (1,200,000 pre-consolidation share purchase warrants), each warrant giving the right to acquire one common share of COPL at an exercise price of $2.00 per share ($0.50 per pre-consolidation share) for a period of one year; these warrants expired on December 11, 2010 (see Note 5b).

The loan agreement also included a provision that in the event the Company completed any financing, the proceeds should be used to first repay the Bridge Loan together with accrued interest. Accordingly, on June 7, 2010, subsequent to the Private Placement (discussed further in Note 5) the Company repaid the Bridge Loan in full, together with $96 thousand of accrued interest.

5. SHARE CAPITAL

a) Authorized and Issued Common Shares

<u>Authorized</u>

An unlimited number of common voting shares (the “Common Shares”) without nominal or par value and an unlimited number of preferred shares, issuable in series.

5. SHARE CAPITAL (continued)

Issued

The issued share capital is as follows:

	Pre-Consolidation Number of Common Shares	Post-Consolidation Number of Common Shares	Amount
Balance, December 31, 2008	**65,608,888**	**16,402,222**	**$ 7,463**
Issued and held in escrow (i)	1,000,000	250,000	600
Balance, December 31, 2009 (i)	**66,608,888**	**16,652,222**	**$ 8,063**
Issued for payment of Bridge Loan fees (ii)	721,694	180,424	167
Issued pursuant to private placement (iii)	27,490,315	6,872,582	6,955
Issued for payment of finders' fees on private placement (iv)	1,042,841	260,711	264
Issued pursuant to public offering – first release condition (v)		78,000,000	29,640
Interest on offering funds held in escrow (v)	-	-	9
Share issue costs (iii & v)	-	-	(3,265)
Balance, December 31, 2010 (i)		**101,965,939**	**$ 41,833**

Further to shareholders' and board of directors' approvals and effective August 3, 2010, the Company's common shares were consolidated on a one for four basis, i.e. one post-consolidation common share for every four pre-consolidation common shares. Common share numbers and earnings per share amounts have been retroactively adjusted to reflect the share consolidation.

(i) The number of common shares includes 250,000 common shares (1,000,000 pre-consolidation common shares) held in escrow. These shares were issued on December 7, 2009, at an issue price of $2.40 per share ($0.60 pre-consolidation) to acquire 100% shares of NSO and COPL UK (as discussed in Note 3). The shares held in escrow are accounted for as contingently returnable shares at December 31, 2010, which were not considered outstanding and are not included in the computation of basic loss per share until they are released from escrow. The transaction was approved by the TSX-V on February 3, 2011 and subsequently the respective common shares were released to the beneficial holders.

5. SHARE CAPITAL (continued)

a) Authorized and Issued Common Shares (continued)

(ii) On May 5, 2010, the Company issued to Endeavour 180,424 common shares (721,694 pre-consolidation common shares) as payment for a fee of $167 thousand in respect of the Bridge Loan. Pursuant to the Bridge Loan agreement, the fee was due if the loan was not repaid in full by April 1, 2010. The number of common shares was calculated based on the 5-day volume weighted average closing price of the Company's shares immediately before April 1, 2010. The fee of $167 thousand was recognized in the Consolidated Statement of Operations, Comprehensive Loss and Deficit as interest and financing charges in 2010.

(iii) On May 14, 2010 and May 21, 2010, the Company closed the private placement of 6,872,582 units at $1.20 per unit (27,490,315 pre-consolidation units at $0.30 per unit) for total gross proceeds of $8.2 million. Each unit consists of one common share and one half of a share purchase warrant. Each whole warrant entitles the holder to acquire an additional common share at an exercise price of $2.00 (pre-consolidation exercise price of $0.50) expiring November 14, 2011. The fair value of the share purchase warrants issued was estimated at $1.3 million using a Black-Scholes option pricing model with the following assumptions:

	2010
Risk-free interest rate	2.0%
Weighted average life (years)	1.5
Expected volatility	100%
Expected dividend yield	0%

All units issued further to this private placement were subject to resale restrictions and could not be resold until four months and one day after the date of issue.

(iv) The Company paid, whenever applicable, a finder's fee by issuing subscription units equivalent to 5% of the units subscribed via a particular broker. As the result, there were 260,711 units (1,042,841 pre-consolidation units) issued as finder's fees, with exercise price and expiry date of the share purchase warrants consistent with the warrants issued as part of the private placement. The value of $313 thousand, representing the subscription value of the units issued as finder's fees together with legal fees of $69 thousand, was recognized as share issue costs. The fair value of share purchase warrants issued as finder's fee was estimated at $49 thousand using a Black-Scholes option pricing model with the same assumptions as noted above. Similar to units issued further to the private placement, the units issued as finder's fees were subject to resale restriction and could not be resold until four months and one day after the date of issue.

5. SHARE CAPITAL (continued)

a) Authorized and Issued Common Shares (continued)

(v) On November 23, 2010, the Company filed a prospectus to obtain financing for its operations in the UK North Sea. The offering provided for the sale of 260,000,000 subscription receipts ("Subscription Receipts") at a price of $0.50 per Subscription Receipt. Each Subscription Receipt entitled the holder to receive one common share of COPL ("Common Share") and one half of one (0.5) common share purchase warrant of COPL ("Warrant"), upon the satisfaction of certain Release Conditions (as defined in the prospectus). Each Warrant entitles the holder to purchase one Common Share at $0.65 within 36 months from the closing date, provided that the Warrants will expire if not exercised within 10 days of notice from COPL that the 20 day volume weighted average trading price of Common shares is greater than $1.25.

The closing of the Offering occurred on December 1, 2010. The gross proceeds from the sale of Subscription Receipts of $130 million were held in escrow pending satisfaction of the First and Second Release Conditions (as defined in the prospectus). The agent was entitled to a cash commission equal to 6% of the gross proceeds of the Offering ("Agent's Fee"), payable at 30% on satisfaction of the First Release Condition and 70% on satisfaction of the Second Release Condition. In addition, upon satisfaction of both Release Conditions, the agent will receive compensation warrants in an amount equal to 6% of the aggregate number of Subscription Receipts sold pursuant to the offering. Each agent's warrant entitles the holder to purchase one Common Share of COPL for the period of 24 months from the closing date at an exercise price of $0.50.

On December 10, 2010, the First Release Condition was met as the Company signed farm-in agreements in respect of the Fulla and Bluebell projects (as defined in the prospectus). Accordingly 78,000,000 Subscription Receipts were converted into 78,000,000 Common Shares and 39,000,000 Warrants, and funds of approximately $36.6 million were released to the Company ($39.0 million gross proceeds, net of Agent's Fee and expenses). The fair value of the Warrants issued further to the first release was estimated at $9.4 million using a Black-Scholes option pricing model with the following assumptions:

	2010
Risk-free interest rate	1.5%
Weighted average life (years)	1.5
Expected volatility	80%
Expected dividend yield	0%

5. SHARE CAPITAL (continued)

On February 22, 2011, the Second Release Condition was met as the Company signed farm-in agreements in respect of North Sea prospects in Block 23/21 and Block 22/15 (as defined in the prospectus). Accordingly 182,000,000 Subscription Receipts were converted into 182,000,000 Common Shares and 91,000,000 Warrants, and funds of approximately $85.5 million were released to the Company ($91.0 million gross proceeds, net of Agent's Fee and expenses). In addition, 15,600,000 agent's warrants were issued, each warrant entitling the holder to purchase one Common Share of COPL for the period until December 1, 2012 at an exercise price of $0.50.

b) Warrants

A summary of status of the Company's warrants as at December 31, 2010 and 2009 is as follows:

	2010		2009	
	Number of Warrants	**Wt. Avg. Exercise Price**	**Number of Warrants**	**Wt. Avg. Exercise Price**
Balance, beginning of year	**425,000**	**$ 2.00**	**-**	**$ -**
Issued	**42,566,646**	**0.76**	**425,000**	**2.00**
Expired	**(425,000)**	**2.00**	**-**	**-**
Balance, end of year	**42,566,646**	**$ 0.76**	**425,000**	**$ 2.00**

The summary of the Company's share purchase warrants issued during the year ended December 31, 2010 is as follows:

	Number of Warrants issued in 2010	**Exercise Price**	**Expiry Date**
Private Placement Warrants (Note 5a iii)	3,436,291	$2.00	November 14, 2011
Finder's Fee Warrants (Note 5a iv)	130,355	$2.00	November 14, 2011
Public Offering – First Release (Note 5a v)	39,000,000	$0.65	December 1, 2013
	42,566,646	$0.76	

No share purchase warrants were exercised during the years ended December 31, 2010 and 2009.

c) Incentive Stock Options

The Company has a stock option plan where the number of common shares reserved under the plan shall not exceed 10% of the issued and outstanding common shares and the number reserved for any one individual may not exceed 5% of the issued and outstanding shares. Exercise prices for stock options granted are determined by the closing market price on the day before the date of grant.

5. SHARE CAPITAL (continued)

c) Incentive Stock Options (continued)

During 2010, the Company granted to its directors, officers, employees and consultants the following stock options, which vest immediately and expire in five years from date of grant:

- On June 1, 2010 - 662,500 stock options (2,650,000 pre-consolidation stock options) to acquire common shares at an exercise price of $1.20 ($0.30 pre-consolidation exercise price). The related stock-based compensation expense of $583 thousand has been recognized in the statement of operations.
- On December 10, 2010 – 7,600,000 stock options to acquire common shares at an exercise price of $0.59. The related stock-based compensation expense of $2.7 million has been recognized in the statement of operations.

The fair value of each option granted is estimated on the date of grant using a Black-Scholes option pricing model with the following assumptions:

	June 2010	December 2010
Risk-free interest rate	2.0%	1.5%
Weighted average life (years)	4.0	4.0
Expected volatility	100%	80%
Expected dividend yield	0%	0%

No stock options were exercised during the years ended December 31, 2010 and 2009.

As at December 31, 2010, 9,592,500 stock options to purchase common shares were outstanding, having a weighted average exercise price of $0.66 per share with a remaining weighted average contractual life of 4.7 years. Changes to the Company's stock options are summarized as follows:

	2010		**2009**	
	Number of Options	**Wt. Avg. Exercise Price**	**Number of Options**	**Wt. Avg. Exercise Price**
Balance, beginning of year	**1,402,500**	**$ 0.80**	112,500	$ 1.00
Granted	**8,262,500**	**0.64**	1,402,500	0.80
Expired	**(72,500)**	**0.80**	(112,500)	1.00
Balance, end of year	**9,592,500**	**$ 0.66**	1,402,500	$ 0.80
Exercisable, end of year	**9,592,500**	**$ 0.66**	1,402,500	$ 0.80

Subsequent to year end, on February 23, 2011 the Company granted to its directors, officers, employees and consultants 12,415,000 stock options to acquire common shares at an exercise price of $0.68. The stock options vest immediately and expire in five years from the date of grant.

6. CONTRIBUTED SURPLUS AND WARRANTS

	2010	2009
Contributed Surplus:		
Balance, beginning of year	**$ 1,074**	$ 289
Stock-based compensation (Note 5c)	**3,243**	785
Balance, end of year	**$ 4,317**	**$ 1,074**
Warrants:		
Balance, beginning of year	**$ 306**	$ -
Fair value of warrants issued in 2010 (Note 5a iii-v)	**10,701**	306
Balance, end of year	**$ 11,007**	**$ 306**

7. FUTURE INCOME TAX

The tax effects of the temporary differences on future income tax assets (liabilities) are as follows:

	2010	2009
Non-capital income tax losses	**$ 2,552**	$ 734
Capital losses	**632**	632
Share issue costs	**653**	20
Office assets	**3**	-
	3,840	1,386
Valuation allowance	**(3,840)**	(1,386)
Future income tax assets (liabilities)	**$ -**	$ -

7. FUTURE INCOME TAX (continued)

The provision for income taxes (recoveries) differs from the statutory income tax rate as follows:

	2010	2009
Provision at statutory rates	**$ (2,610)**	$ (925)
Non-deductible items		
Stock-based compensation	**908**	228
Amortization of warrants	**83**	-
Other	**23**	5
Share issue costs	**(859)**	-
Effect of tax rate changes	**210**	130
Change in previously estimated tax pools	**(212)**	-
Change in valuation allowance	**2,454**	-
Other	**3**	562
Future income tax provision (recovery)	**$ -**	$ -

As at December 31, 2010, the Company had approximately $10.2 million (2009 - $2.9 million) of non-capital losses, which can be applied against taxable income earned in Canada with following expiry dates:

- $4 thousand on December 31, 2014
- $91 thousand on December 31, 2026
- $253 thousand on December 31, 2027
- $130 thousand on December 31, 2028
- $2.5 million on December 31, 2029
- $6.4 million on December 31, 2030

As at December 31, 2010, the Company also had capital losses of approximately $5.1 million (2009 - $5.1 million) which carry forward indefinitely to reduce capital gains.

8. COMMITMENTS AND CONTRACTUAL OBLIGATIONS

As at December 31, 2010, the Company has the following contractual obligations:

	Total	**Less than One Year**	**One to Three Years**	**Four to Five Years**	**After Five Years**
Farm-in commitments	**22,000**	22,000	-	-	-
Office lease	**4,321**	535	1,069	1,069	1,648
Financial advisory services	**75**	75	-	-	-
	26,396	22,610	1,069	1,069	1,648

8. COMMITMENTS AND CONTRACTUAL OBLIGATIONS (continued)

Further to two farm-in agreements signed in December 2010 in respect of exploration prospects in the UK North Sea, the Company is committed to participate in drilling two exploration wells in 2011 at an estimated cost of $22 million net to the Company.

The Company is committed under an operating lease agreement for the rental of office space in Calgary. The approximate lease payments total $4.3 million and are payable over the next 9 years.

The obligation in respect of financial advisory services relates to an agreement with Endeavour International. The agreement is in effect until June 10, 2011, with an option to extend, if agreed by both parties.

Subsequent to December 31, 2010, the Company has signed a third farm-in agreement in respect of exploration prospects in the UK North Sea. Under this agreement, the Company is committed to participate in drilling a minimum of three exploration wells in 2011 at an estimated cost of $44.6 million net to the Company. Subject to positive results of these commitment wells, the Company has contingent obligations to participate in well testing and in the drilling of two contingent wells.

9. RELATED PARTY TRANSACTIONS

Transactions with the Company's directors and officers in the form of consulting services totaled $622 thousand for the year ended December 31, 2010, compared to $789 thousand for 2009. These transactions occurred in the normal course of business and have been recorded at exchange amounts based on commercial rates and terms agreed to in the related consulting contracts.

As at December 31, 2010, $31 thousand was payable to related parties in respect of consulting fees, as compared to $701 thousand of accrued consulting fees as at December 31, 2009.

In addition, in 2009 the Company acquired 100% of the outstanding common shares of NSO and COPL UK in a non-arm's length transaction as discussed in Note 3.

10. FINANCIAL INSTRUMENTS

The Company has classified its cash and cash equivalents and term deposits as financial assets held-for–trading and has measured them at fair value. Accounts receivable and prepaids are classified as loans and receivables; accounts payable, accrued liabilities and loans are classified as other liabilities; these items are measured at amortized cost.

(a) Fair values

The Company categorizes its financial instruments carried at fair value into one of three different levels depending on the observability of the inputs employed in the measurement:

- Level 1 – includes assets and liabilities measured at fair value based on unadjusted quoted prices for identical assets or liabilities in active markets that are accessible at the measurement date;
- Level 2 - includes assets and liabilities measured at fair value using directly and indirectly observable inputs other than quoted prices included in Level 1;
- Level 3 - includes assets and liabilities measured at fair value based on inputs which are less observable, unavailable or where observable data does not support a significant portion of the instrument's fair value.

10. FINANCIAL INSTRUMENTS (continued)

a) Fair values (continued)

As at December 31, 2010 and 2009, the fair values of all financial instruments not carried at fair value approximated their carrying values due to their short-term maturity. Cash and cash equivalents and term deposits have been categorized as Level 1 financial instruments.

(b) Credit risk:

The Company's accounts receivable are mainly due from the government (Goods and Services Tax) and from its consultants in respect of travel advances. The Company believes there is no unusual exposure associated with these receivables. No amounts are considered to be past due and no allowance for doubtful accounts has been recorded in the account. As at December 31, 2010, the Company holds $37.4 million of cash and cash equivalents with Canadian chartered banks. Management has assessed the associated credit risk as relatively low.

(c) Interest rate risk:

The Company's policy is to invest excess cash in redeemable guaranteed investment certificates ("GICs") issued by its banking institutions. The Company periodically monitors the investments it makes and is satisfied with the credit ratings of its banks. As of December 31, 2010, the Company's cash and cash equivalents balance included $500 thousand in redeemable GICs, maturing January 7, 2011.

11. CAPITAL MANAGEMENT

The Company's objectives when managing capital are:

- to safeguard the Company's ability to continue as a going concern;
- to maintain balance sheet strength and optimal capital structure, while ensuring the Company's strategic objectives are met; and
- to provide an appropriate return to shareholders relative to the risk of the Company's underlying assets

In the management of capital, the Company includes shareholders' equity (deficiency) and interest bearing debt defined as long-term loans and current portion of long-term loans. Shareholders' equity includes share capital, warrants, contributed surplus and deficit.

The Company maintains and adjusts its capital structure based on changes in economic conditions and the Company's planned requirements. The Company may adjust its capital structure by issuing new equity and/or debt, selling and/or acquiring assets, and controlling the capital expenditure program.

The Company is not subject to any external capital requirements. There were no changes in the Company's capital management policies during the year.